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SUPPORTING MICRO AND SMALL SCALE ENTERPRISES: WHAT CAN BE LEARNED FROM DONOR PROGRAMS?

by

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Abstract

This paper summarizes the evaluations of micro and small scale enterprise projects financed by the U.S. Agency for International Development, the European Investment Bank, the International Labor Office, the United Nations Capital Development Fund, the United Nations Development Program, and the World Bank. The evaluations suggest that a concensus is emerging towards the idea that minimalist credit projects offer the best method of providing sustainable services valued by small scale entrepreneurs. There is considerable disagreement, however, about the economic role that micro and small scale enterprises play in the economies of developing countries, and the economic benefits obtained from assistance programs designed to support them if they have debateable efficiency and prospects for growth.

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INTRODUCTION

Considerable attention has been focused on rural nonfarm enterprises in recent years by donor agencies and development specialists. Micro and small scale enterprises have also been the subject of many recent studies. Undoubtedly, some of this interest is due to the growing realization that large scale, modern industrialization strategies of previous decades have failed to solve the problems of underemployment and poverty (Liedholm and Mead). In recent years, it has been popular to view support for microenterprises as being an effective way to stimulate the private sector's contribution to growth and equity objectives of developing countries. Nongovernmental (NGOs) and private voluntary organizations (PVOs) have become particularly active in support programs of credit, training and technical assistance for urban and rural small scale enterprises.

The purpose of this paper is to present a summary of the large and growing literature about donor experience in attempting to meet employment and income objectives through assistance to the rural nonfarm sector with particular emphasis on micro and small scale enterprises. Key conclusions about these experiences are presented with emphasis on those with implications for rural development in the Philippines, and for the research to be conducted in the Dynamics of Rural Development Research Program of PIDS. Much of the literature available in this field is of two types. One type concerns the experience of the donor or international agency in providing assistance to countries through projects designed for micro and small scale enterprises. Many of these enterprises are located in rural areas and/or are closely linked to the agricultural sector. Since many of the assistance projects involve credit, this paper necessarily focuses on the lessons learned in attempting to provide credit services to this target clientele. The second type of literature concerns an economic analysis of the group or sector being assisted. This literature seeks to answer economic questions such as the role of micro and small scale enterprises, many located in rural areas, in creating employment and generating income, the efficiency and profitability of various firm sizes, and the dynamic process of enterprise creation and growth.

A COMMENT ON DEFINITIONS

The first problem encountered in conducting a literature review encompassing several studies, countries, and authors is the wide range of definitions used to identify and study enterprises, firms and sectors. The terms "small" and "micro" are used to describe size of firm, usually measured in terms of employment or assets. The term "microenterprises" refers to the smallest size firms, frequently employing only the owner/entrepreneur and his/her family with only a few hired workers. Although some small scale firms operate on a modern industrial basis, most are generally organized as "cottage industries" with limited management specialization and division of labor. The terms small and micro also frequently imply "informality" because these firms tend to fall outside the sphere of influence, regulation and support of government. Informality gives these firms the advantage of avoiding restrictive government regulations, but also can restrict their access to formal finance, and broader markets, technologies and information systems that would enable them to grow and benefit from economies of scale.

The term "nonfarm enterprises" has been applied to the heterogenous set of enterprises that are found on and off farms, but that are not included in the typical farm production study (Meyer, 1991). Processing activities conducting within the farm household are often included within this definition. In addition, these enterprises include economic activities found in villages and small towns, often closely linked to agriculture by providing inputs, or processing and marketing farm outputs. These enterprises are distributed across all firm sizes, but much of the research has focused on those which fall within the micro and small size category.

The emphasis of industry studies tends to be on "manufacturing", but in fact the rural nonfarm sector includes a wide range of service and trading enterprises and other firms indispensable to the agricultural sector, and that provide a large amount of employment and income, especially for women, in many countries. Most donor credit programs, however, have only recently recognized the value of including non-manufacturing activities in their list of projects eligible for funding through subloans.

For the purposes of this paper, the term rural nonfarm enterprises will be used to encompass that heterogenous set of economic activities that are found on and off the farm, but usually strongly linked to agriculture. They tend to be small in size, measured in assets or employees, use largely traditional methods of production and simple forms of organization. No effort is made to specifically include "agribusinesses" in this review because the agribusiness literature often focuses on larger size firms, frequently with international linkages, and using modern production, processing and marketing techniques. Undoubtedly, large scale agribusinesses are important in shaping the speed and nature of rural development, and in indirectly creating opportunities for smaller scale, more traditional enterprises in the rural nonfarm sector. However, they are less frequently the focus of donor assistance programs, and in some countries there is a sharp debate about the growth and equity implications of using large scale, multinational agribusinesses as the engine of rural development. It is possible that broader based, more equitable development will occur through stimulating the growth of smaller, more traditional enterprises and firms.

DONOR EXPERIENCES

Several reports summarizing donor experiences and recommendations concerning rural and microenterprises are now available. The purpose of this section of the paper is to highlight the key findings of several recent reports.

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT (AID)

In many ways AID has been a leader among the donors in support programs for micro and small enterprises. The early PISCES project evaluated several attempts to provide assistance to these enterprises. Later, the ARIES project and now the GEMINI project continue that tradition. AID has also been important in supporting research about small enterprises and the rural nonfarm sector. Carl Liedholm and colleagues at Michigan State University have conducted research in this field with AID support since the 1970s. HIID at Harvard has a long history of research on the financial sector of Indonesia, some of it supported by AID, that has helped reveal how financial reforms in that country have helped the small scale sector. Finally, in 1988 and 1989, AID undertook and published the results of a major stocktaking of its experience in microenterprise development (Boomgard).

Liedholm and Mead prepared a paper in 1987 that represented a comprehensive synthesis of MSU research findings up to that date. The conclusions were largely drawn from in-depth studies conducted in selected survey areas in six countries: Sierra Leone - 1974-75; Bangladesh - 1978; Jamaica - 1978; Honduras - 1979; Thailand - 1979; and Egypt - 1981. The small scale industries studied included those establishments with fewer than fifty workers engaged in manufacturing activities or related repair work.

The analysis of the sampled firms revealed that they collectively account for the vast bulk of industrial employment, are located in rural ares (localities with less than 20,000 inhabitants), most are very small employing fewer than five persons, virtually all are privately owned and are organized as sole proprietorships, and the proprietors and family workers make up most of the labor force. The amount of capital used by these firms is modest but larger than that required for petty trading or unskilled service activities. Most of the funds for establishing or expanding these firms comes from personal savings, relatives or retained earnings. Only a small amount came from formal financial sources or governments. The economic activities of these small scale firms appear to be increasing in absolute terms along with the employment absorbed by the small scale private sector.

The factors influencing the demand for and supply of small industry goods and services produced by the small scale industries were examined. Contrary to the expectations that these firms produce inferior goods, recent studies have revealed a strong positive relationship between demand and growth of household income. A second source of demand is found in the strong backward and forward linkages with the rest of the domestic economy, especially agriculture and large scale industry. On the other hand, government and foreign demand was limited for most firms.

With respect to supply, most studies reveal that small scale industries are efficient users of capital by generating more employment per unit of capital than large scale firms. Output per unit of capital of small firms also tends to exceed large firms. Studies of the social benefit cost ratio of small versus large firms in Sierra Leone, Honduras, and Jamaica revealed they were greater than one and larger for small firms in 10 out of 12 industry groups analyzed, but there are wide variations in efficiency among the small firms. The small firms that are most likely to be economically efficient tend to: 1) use hired workers, 2) operate in workshops away from the home, 3) operate in localities with more than 2,000 inhabitants, and 4) are involved in product lines with better economic prospects, such as tiles, furniture, baking and repair activities. An important finding is that one-person firms were frequently on the margin of economic viability.

Liedholm and Mead concluded that small scale firms can be enhanced by policy changes that reduce the bias against small firms, and especially those controls that restrict interest rates and encourage lenders to ration scarce funds to traditional larger scale clients. Policies that promote small scale farming are also important because of the powerful stimulus for small scale enterprises.

Projects rather than policy reforms, however, have been the primary methods used by government and donors to support small enterprises. Relatively few entrepreneurs receive this assistance, however. Special credit programs designed to assist small and medium size firms often end up providing little credit to the smallest firms. The AID stocktaking, however, concluded that some programs can reach the smallest firms on a self-sustaining basis with minimal subsidies. Liedholm and Mead argue that the most successful programs that provide nonfinancial assistance are those that attempt to supply a "single missing ingredient", but that position has been debated by Boomgard. They also argue that projects assisting existing firms are more likely to be successful than those attempting to establish new ones. Similar to the World Bank experience summarized below, they argue that successful projects tend to be built on proven existing institutions.

The AID stocktaking evaluation represented a major effort by AID to evaluate what was learned about what works and what doesn't work in its microenterprise projects (Boomgard).[1] It focused on identifying projects and programs with proven effectiveness in generating and sustaining developmental benefits, and in analyzing the factors responsible for their success. Throughout the study, microenterprises were defined as firms that employ 10 or fewer full-time workers.

By the mid 1980s, AID was involved in at least 87 active microenterprise projects or programs in 35 countries. A purposive sample of 32 projects and programs located in 20 countries was selected for detailed study in the stocktaking. They were selected because they targeted assistance to microenterprises, and some analysis of beneficiary impact was available. In almost all cases, the project or program studied either began operations in the 1980s or AID's involvement began at that time. Data were obtained from existing

[1] This section draws heavily from my earlier review of the Boomgard report. Another synthesis of the stocktaking evaluation was published by Levitsky.

evaluations and site visits to 10 countries. Seven programs were selected from Asia, including the large scale Indonesian BKK program, 11 from Africa, and 23 from Latin America. They are being implemented by PVOs, government agencies and credit unions. Some programs provide only credit to their beneficiaries, while others also provide training and technical assistance.

Three distinct approaches to enterprise development were identified in the study. The **enterprise formation approach** attempts to help highly disadvantaged groups or individuals from the survival economy develop viable businesses. Programs following this approach often serve a relatively large proportion of new entrepreneurs and offer a comprehensive range of services focused on the creation of rudimentary business skills, resulting mostly in income generation rather than in new employment.

The **enterprise expansion approach** tries to improve the performance of existing microenterprises. It is essentially minimalist because it emphasizes small improvements for many firms, often providing only credit. The graduation of firms into small enterprises is largely left to natural selection, rather than project effort.

The **enterprise transformation approach** actively tries to graduate entrepreneurs from micro to small enterprises, often by providing an integrated mix of credit, training, and technical assistance. The firms assisted are typically somewhat larger than those involved in the other approaches so employment generation plays a relatively larger role. Both the formation and transformation approaches are transformation-oriented, and place heavy emphasis on technical assistance and training. The expansion approach, on the other hand, tries to support existing enterprises, and this accounts for the minimalist credit orientation.

Six of the sampled projects and programs were found to emphasize enterprise formation, 22 enterprise expansion, and 14 enterprise transformation. Because of multiple subprojects, the total number exceeds the total sample size. A relatively small number of programs in Latin America emphasize enterprise formation, while a relatively large proportion in Asia and the Near East fall in the expansion category. The sampled programs were evaluated on three criteria: beneficiary impact, cost-effectiveness, and institutional sustainability. The latter criteria considered the three dimensions of financial, organizational and environmental sustainability.

The principal results of the evaluation are summarized in Table 1. The enterprise expansion data are presented in columns three, four and five. Column three gives the results for these programs treated together. Since the group is heterogeneous, the results for the six programs which operated primarily as financial institutions are presented separately in column four, and the results for the remaining programs are summarized in column five. In several cases data are missing, and in other cases there was wide variance among the programs within a particular group. Therefore, some of the differences in mean values appear large but are not statistically significant, as noted in column seven.

Most microenterprise programs serve only a few hundred clients; the exceptions are the financial institutions that serve thousands. Women represent a significant share of total beneficiaries in all programs. The formation and transformation programs tend to serve a larger percentage of manufacturing firms compared to other types, but the differences are not significant. Average program costs also are higher, but not significant, for these programs as would be expected with the larger amount of training and technical assistance provided their clients.

The average loan size in transformation programs exceeded $3,000 compared to approximately $500-700 in the other programs. This finding suggests that attempts to graduate microenterprises to small scale firms requires a large enough change in the firm to justify a relatively large loan. The relative loan size can be seen by comparing average loan size relative to GDP per capita. The transformation programs provide loans that average ten times the average GDP per capita, while other programs provide loans roughly one to two times GDP per capita.

Most programs provide 25 to 45 percent of their loans to finance fixed assets. The financial institutions in the expansion programs, however, provide mostly working capital which is consistent with their objective of helping clients make marginal improvements in their businesses. By lending mostly working capital, these institutions also face less stringent staff requirements, so it is easier to operate large scale institutions reaching thousands of clients.

The data in the bottom three lines of Table 1 give some indication of the comparative cost-effectiveness and financial sustainability of the programs. Because of the modest services provided and their large scale operations, the average program cost is lowest for the expansion programs with an average of just under $0.50 per dollar lent. Transformation programs on average cost double that amount, while formation programs cost six times more. One good indication of a program's ability to recover costs is reflected in the interest rate charged on loans. The expansion programs charge real interest rates that average up to 25 percent, while the other programs have a large subsidy element because they only charge 0 to 3 percent. Even the relatively high rates in the expansion programs do not cover program costs however.

The challenge to recover costs is further complicated by loan delinquency and default. The programs report loan arrearages ranging from 16 to 24 percent on average. If only half of these actually result in losses, loan losses of 8 to 12 percent are too high for most programs to sustain without continuous infusions of outside funds. The expansion programs come closest to meeting self-sufficiency, but generally the other programs are far it. Financial self-sustainability is closest to being achieved in the best managed programs which limit their assistance to low cost financial services, such as the BKK and KUPEDES programs in Indonesia. Importantly, it was observed that credit programs that strive to become self-sustaining, even when the goal is unattainable, generally perform better than those that expect continuing external support. Organizations that think of themselves as businesses that live or die on the basis of earnings behave differently than if they are not subjected to this market test.

The evaluation concludes that direct assistance programs that aim to improve the performance of microenterprises without attempting to transform them into more complex businesses have a better record of achievement than do more ambitious transformational programs. They typically provide small working capital loans with efficient screening, rapid disbursement and a reasonable assurance of the availability of larger loans upon repayment. The beneficiaries are poor, but not the poorest of the poor. Benefits of the programs are modest for each client, but increase the income of many clients rather than create large amounts of employment. The organizations implementing these programs adopt a businesslike attitude towards achieving a large volume of lending and operate in a market area large enough to achieve economies of size. The evaluation also identified important qualitative factors affecting institutional performance, such as a clear, unambiguous mission, strong leadership, well-trained and dedicated staff, good management information systems and an ability to adapt to changing circumstances.

The stocktaking results present a dilemma for microenterprise support programs. On the one hand, programs may reach a large number of participants on a self-sustaining basis if they limit their support to small working capital loans. But this limited service may not meet the total needs of many enterprises. On the other hand, it is more difficult to achieve self-sufficiency if programs attempt to provide expensive training and technical assistance services for their clients. Furthermore, graduation from special microenterprise programs is difficult so an alternative is to graduate entire microenterprise programs into credit retailers for larger size loans for longer term purposes.

In spite of the mixed results achieved in these programs and projects, the report recommends that AID continue to fund microenterprise support projects. One reason is related to AID's interest in stimulating policy change. The overall business and economic environment in a country has a strong influence on the opportunities available for profitable business ventures. By promoting successful microenterprise interventions, AID can become involved in policy dialogue concerning the need for and desirability of policy reforms. AID can also be a strong advocate for the small business community. Implementing projects provides a practical way to accumulate information and influence decisions in addition to supporting research or including conditionality in foreign assistance programs.

A second benefit of AID support of microenterprise projects concerns the development of financial markets. The report argues that formal financial institutions resist lending to the small scale sector not so much because of perceived risk but because of huge transaction costs. Innovations to reduce these costs that are introduced, tested and perfected in projects may open up formal lending to successful small scale entrepreneurs. These innovations may also lead to the development of new lending institutions willing to serve a small scale clientele.

EUROPEAN INVESTMENT BANK (EIB)

The European Investment Bank (EIB) completed a review of its lending program for small scale enterprises in 1989. The results were reported in APRODI, EIB and by Carter et al. Except as noted, this synthesis is drawn from Carter et al.

Since 1976, the EIB has financed projects in 66 ACP (Asian, Caribbean and Pacific) countries with its own resources raised in international capital markets and with risk capital provided by the EC countries. Frequently, own resources are used for on-lending, while risk capital is used for equity participation or studies. About 22 of its operations have been channelled through local financial institutions, generally development finance corporations (dfcs). In the 12 year period ending at the end of 1988, US $363 million had been committed of which nearly 60 percent went to 660 SME projects. Two thirds of the funds came from own resources and one third from risk capital. A total of 42 countries participated (27 African, 11 Caribbean, and 4 Pacific) of which 16 were classified as poor with per capita incomes of less than $450. Operations in the lower income countries have benefitted most from risk capital.

The average size of subloan in these projects was substantially larger than AID projects at $322,000, but a third were for less than $165,000. The average size tended to be larger in larger countries. The real average size has been falling over time suggesting that the dfcs are becoming more effective at reaching smaller entrepreneurs. Sixty percent of the enterprises financed employed less than 50 employees, and 40 percent has annual expected sales of less than $850,000 per year. Since most dfcs are prevented from funding publicly owned enterprises, most enterprises are owned by local businessmen, and more than half by a single family.

About 60 percent of the subloans went to finance new projects, 26 percent to expand existing enterprises, and 14 percent to rehabilitate and modernize enterprises. About two-thirds were for import substitution, 17 percent for export projects, and 19 percent for services. Foodstuffs, tourism and textiles received the largest total allocations. The majority of projects were close to a debt/equity ratio of 2:1, but equity contributions were higher for new projects. The ex-ante economic rate of return was estimated at over 20 percent for 77 percent of the subloans, and between 11 and 20 percent for 20 percent indicating that expected returns are quite high. The projects in total were expected to directly create 28,000 jobs at an average cost per job created of $28,000.

A post-implementation review was undertaken by having the dfcs respond to a questionnaire for a random sample of 120 projects. Interpretation of the results requires caution because the dfcs might have given more favorable responses than are justified, and the impact of structural adjustment recently undertaken in some countries may produce greater financial problems for some projects in the future than reported here.

The review showed there was a weak correlation between the ex-ante rate of return and project success, and projects tend to do well if they get off to a good start. Excluding projects for which a company had not yet been established, at the time of the survey about half of the borrowers operated profitably, a third operated at a loss, and the remainder were in receivership or liquidation. These proportions were not significantly different across the three regions. The most commonly cited reason (45 percent) for difficulty or failure was market problems, especially dominant in the Caribbean. Technical and management problems were listed next, and a shortage of foreign exchange ranked third. The results suggest that market forecasts of borrowers tend to be overly optimistic, and the difficult economic circumstances in many ACP countries is manifest in weak markets rather than foreign exchange shortages for entrepreneurs. Data on project capacity utilization also reflected over-optimism in project appraisals. The average capacity utilization was about two thirds, but was significantly higher (70 percent) for expansion projects, and lower (55 percent) for new projects.

The more successful projects as measured by company profitability were generally of two types: a) export oriented using local raw materials, and b) domestic oriented using imported raw materials. Capacity utilization was highest in the former. Structural adjustment which changed relative prices in favor of domestic inputs appears to have benefitted export oriented firms. Conversely, the domestic oriented firms using imported inputs may have benefitted by high levels of protection which may put them in difficulty in the future with structural adjustment.

The financial structure of a project was not an important source of project failure, and many industries were able to bear foreign exchange risks without prejudicing their financial stability. About a third of the projects had been in arrears on their loan payment to the dfc, and about a third had rescheduled their loans. On the other hand, nearly 90 percent of the profitable SMEs never had problems with debt service.

The evaluation highlighted the importance of the quality of the assistance given by the dfcs to local entrepreneurs (EID). The on-lending rates of many institutions have often been too low relative to inflation and to the margins required for sustainability. This problem plus their internal weaknesses in appraisal and supervision contribute to the financial difficulties of many dfcs. When subloans experienced problems, the dfcs have rarely been in a position to provide anything other than purely financial solutions.

The evaluation also noted the need for greater stability of economic policies if SMEs are to prosper. Greater use of the commercial banking system in projects was also advocated to help develop local financial markets and financial intermediation. The EID was encouraged to provide greater support for technical assistance in its projects, to allow lending rates to be determined by market forces, and, contrary to the views of several other donor agencies, to more effectively target economic sectors, scale of enterprises, and sizes of subloans.

INTERNATIONAL LABOR OFFICE (ILO)

The ILO recently completed its second progress report summarizing activities undertaken within the World Employment Program in the field of rural small industries and nonfarm activities (ILO). These include research; advisory services to governments; design and implementation of technical cooperation projects; evaluation of projects, programs, and policies; and collection and dissemination of information. The report contains a summary of the evaluations that assess the impact of their projects on rural small industrial enterprises (RSIE). The evaluation conducted by the ILO, UNDP, UNIDO and the government of the Netherlands between 1985 and 1987 appears to have had a major impact on ILO views. This evaluation produced several recommendations with some of the most relevant ones summarized as follows:

1. Macroeconomic policies. Macro policies that favor growth of rural income should be given priority in RSIE development strategies and preferably should precede supply-side support measures. Likewise, the development of an agricultural surplus is a precondition for stimulating RSIE. Donors and agencies should focus on persuading countries to adopt appropriate macro policies or insist on these policies as a precondition for supply-side assistance.

2. RSIE support programs. Supply-side support to enterprises is most effective if the demand environment is favorable and if it consists of partial input "missing ingredient" support to existing RSIE. Subcontracting from larger to smaller industries should be promoted through special training and extension programs. General purpose small industries development agencies should concentrate on those functions

they perform most effectively. Credit should be made available in as decentralized a form as possible, and the role of non-bank financial intermediaries should be enlarged. Mobile training units should be stimulated for technical upgrading programs. Greater use should be made of NGOs and PVOs as agents of change. Existing institutions should be used to implement projects rather than setting up new ones. Technical cooperation designed to strengthen RSIE institutions should first carefully screen them for their effectiveness.

3. Donor coordination. Donors and agencies should harmonize their external assistance procedures and coordinate their field activities in support of RSIE.

It is obvious from this synthesis that the ILO has been heavily influenced by the idea that macroeconomic policies must be set right before RSIE projects can expect to be effective. There are no suggestions presented, however, as to how changes in policies might have a differential impact on certain types and sizes of firms, and therefore influence the effectiveness of RSIE projects. As noted in the EIB evaluation, policy reforms will likely improve economic prospects for some small firms, while making it more difficult for others. This fact will have an impact on projects that target specific firms.

UNITED NATIONS CAPITAL DEVELOPMENT FUND (UNCDF)

A review was conducted of the credit components of projects funded by the United Nations Capital Development Fund - UNCDF (Jackelen). From 1966 to December 1987, the UNCDF obligated $112 million in 93 projects with credit components in 17 mostly Asian and African countries. The credit components amounted to $31 million channelled through a variety of delivery mechanisms. Eighty-three of the 93 projects were concentrated in agriculture, industry and irrigation.

Fifteen projects representing 30 percent of all budgeted credit components were selected for a detailed desk review. Three types of credit delivery mechanisms were used in these projects: Type A - financial institutions; Type B - grassroots institutions including cooperatives, village associations and communities; Type C - a mix of financial and non-financial institutions. Two small industry projects in Burundi and Yemen fell into the Type A category. These projects encountered problems of the type frequently alleged to prevent financial institutions from making small industry loans, namely security requirements were high even when the project specifically exempted them, transaction costs were high for small loans, the loan approval process was time consuming, and the financial institutions have little capacity for outreach and supervision of loans made. Recovery rates were low not necessarily because of financial difficulties of the entrepreneurs, but because of the perception that the loans were "soft."

Two small industry projects in The Gambia and Bangladesh fell into the Type C category using a combination of financial and non-financial institutions. In these two cases, a bank was used to provide loans, while a government extension service provided direct assistance to borrowers. Both projects were poorly implemented because of a lack of clear definition of responsibilities, field staff were not effective and neither project had a well-developed staff training program, the banks did not have adequate accounting systems to provide timely information on problem cases, and the projects were not designed to develop adequate delivery mechanisms to accomplish their goals.

The evaluation concluded that the sampled projects, regardless of type or sector of operations, shared a number of weaknesses. They included a lack of clear definition about the role of the credit or revolving funds provided by the UNCDF to the project, interest rates too low to cover costs, a neglect of savings mobilization and good accounting and management information systems, an inability to properly assess the capabilities of the participating institutions prior to project start up, a lack of effective technical assistance for these institutions, especially in the critical linkage between the delivery institution(s) and the borrowers, and a failure to incorporate traditional informal credit customs and practices into the projects.

In spite of the evaluation's generally negative conclusions about UNCDP credit projects, it recommends that credit projects should continue to be part of UNCDP programs. A variety of recommendations are made about how to make them more effective. Little is said, however, about the nature of the economic activities to be funded and the problems that projects can expect to face when serving low income people who are the clientele of UNCDF programs.

UNITED NATIONS DEVELOPMENT PROGRAM (UNDP)

An evaluation of credit programs of the UNDP is reported in Ashe and Cosslett. A review was conducted of 750 projects approved by the UNDP between January 1987 and mid-April 1988 to determine which were related to credit. A total of 51 (7.1 percent) of the projects either related to or contained credit. The detailed breakdown was as follows:

1. 33 Type I projects with a credit component,

2. 8 Type II projects in which the UNDP provides technical cooperation to UNCDF projects that contain credit,

3. 3 Type III projects in which the UNDP provides technical cooperation for credit funds provided by international development banks, and

4. 7 Type IV projects in which the UNDP provides technical cooperation to credit operations in the banking sectors of developing countries.

A total of $62.6 million, or 6.8 percent of UNDP funds, went to these projects. Projects in Africa and Latin America/Caribbean received most of the funds in all categories of project types.

For the Type I and II projects, 44 percent were directed at microenterprises, 34 percent served farmers, 7 percent assisted fishermen, and 2 percent provided credit to assist housing construction. Poor people were predominately the intended beneficiaries for 70 percent of the projects. The majority of the credit components were in the form of revolving funds, and the second most common type were guarantee funds. The project documents contained little information about the design of credit components, operational costs or project efficiency, cash flow, loan payment, probable project impact, or demand for funds. Sixty-one percent of the projects lack information on the likely number of borrowers to be served, 85 percent lack information on estimated loan size, 76 percent do not specify length of loan, and 83 percent fail to indicate interest rates to be charged. With this information lacking, it was impossible to estimate the sustainability of most projects.

To assess UNDP experience with project implementation, 16 credit projects were selected for a review of their evaluations and project files. More than half the projects were executed by FAO in agriculture, forestry and fisheries, so there is limited information on rural nonfarm or microenterprises per se. In fact, all the project evaluations were sketchy and important basic information, such as amount of funds disbursed and average loan size, was not provided. Sustainability was a key problem identified in the evaluations. In some cases the loan fund was not sustainable due to inflation and poor loan recovery. Secondly, institutions were not created that are able and willing to provide credit to the poor on a long-term, on-going basis. Thirdly, there were not sustainable increases in capital for loan programs provided either out of domestic or donor sources.

This evaluation also contains a set of guidelines for the design and implementation of effective credit projects. The guidelines argue that credit projects will be most successful if the borrower, among other characteristics, is a member of a solidarity group or other group guarantee, has a need for short-term credit, and have two employees or less. These recommendations, therefore, imply a minimalist, non-targeted, solitary based approach to microenterprise lending. No attempt was made in this evaluation to define the type of borrowers or sectors that are likely to be successful over the long-term.

WORLD BANK

A comprehensive review of fifteen years of World Bank experience in lending to small and medium enterprises (SMEs) was recently completed by Webster.[2] The general objectives of these projects include: strengthening the financial and technical institutions that serve SMEs, job creation, and correction of financial market imperfections that

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[2] A summary of the report is also available in the 1990 journal article cited in the bibliography. Both the original report and the summary were drawn upon for this synthesis.

constrain small borrower access to credit. The review evaluated 70 World Bank projects in 36 countries representing $3.2 billions in loans covering the fiscal years 1973 (when Bank SME lending was initiated) through 1989 (when 33 of the projects were completed).[3] The study emphasized how to build viable and sustainable financial and technical assistance programs serving SMEs, and does not deal with financial and industrial policy reforms or project impact at the firm level.

Projects in the Asian and Latin American regions each represented about one-third of the volume of loans made, but the African region had the largest number of total projects (21 out of 70) and is the region where World Bank SME operations are increasing. Almost 60 percent of the funds disbursed in the 33 completed projects went to firms engaged in metal products, food processing, and textiles and garments. The average subloan size for the completed projects was $35,000, but within a project there is a wide range in subloan sizes. The fact that actual subloan sizes were far below the maximum allowable is interpreted as evidence that retail banks will not always make only the largest loans authorized in a project. Projects in Asia and Latin America have been able to reach smaller borrowers than in other regions because the pool of eligible borrowers is larger, commercial banks have been used more frequently than development banks and they tend to make

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[3] There are some discrepancies in the amount of SME lending reported by the World Bank. Webster reports that SME lending since 1980 has been relatively constant averaging about $200 million annually. Dessing, however, states that 42.3% of the $11 billion lent by the Bank to the private sector was channeled to SMEs from 1983 to 1988 (p. 2). This would imply $800-900 million lent per year during that period.

smaller loans, and the cost of doing business is lower, especially compared to the African region.

The completed projects created an estimated 600,000 jobs with approximately half this total represented in just two projects in Indonesia. The average cost per job created was $4,675. Many Asian projects performed well in creating a large number of jobs at an average cost of $3,171, compared to $9,850 in Africa. The African projects appear to involve relatively more subloans to purchase capital equipment rather than using existing equipment and increasing the number of people employed as appeared to be the more common approach in Asia.

The projects were evaluated on three criteria: the loans were small, the number of jobs created surpassed expectations, and the institutions were substantially improved through the project. For completed projects, 55 percent (18 of 33) achieved or surpassed at least two of the three primary objectives, 12 percent reached one objective and 33 percent failed to reach any of the primary goals.[4]

The more successful projects had many of the following characteristics:

1) Presence of favorable pre-existing country conditions, such as:

   a) strong demand for services provided by the project,

   b) effective institutions and individuals,

   c) sufficient leadership and commitment to the goals of the project, and

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[4] The first World Bank SME project in the Philippines was classified in the second group, while the second project fell into the first group.

d) political, economic and regulatory environments stable enough to allow project completion without frequent and substantial shifts in policies and institutional leadership.

2) Selection of the strongest available institutions to implement projects, which sometimes required resisting governmental pressures to utilize poorly functioning public agencies.

3) Good project designs matching local demand for services with existing operations and capabilities of implementing institutions. The better projects shared these design characteristics:

a) they were extensively prepared with in-depth analysis of the most promising sub-sectors to promote,

b) demand for credit and technical assistance was judged fairly accurately,

c) delivery systems were designed to fit within existing institutional operations, and

d) program size and complexity were consistent with institutional ability.

4) Particularly capable individuals held key leadership and management positions in the project delivery system.

The sustainability of credit and technical assistance programs was evaluated by assessing subloan repayment rates, the degree to which institutions incorporated SME services into their normal operations, and the record of repeat projects in given countries. The average repayment rate was 80% (highest of 92% in Latin America, and lowest of 61% in Africa). Eight of the 33 completed projects had subloan repayment rates of 90% or more, 15 had rates of 70 to 90 percent, and 10 had rates below 70 percent. A positive correlation was found between high repayment rates and per capita GNP, but little correlation between repayment and overall macroeconomic and regulatory conditions, and business environment. A consistent feature of successful projects was the retail banks' abilities to select viable subprojects, disburse funds efficiently and supervise projects.

World Bank SME credit projects employ lines of credit for borrowers channeled through the formal banking system, either directly to a single intermediary or through a second-tier system to retail banks. Forty-two of the projects employed apex credit delivery systems, 12 involved disbursements by development finance institutions, and 16 used alternative arrangements. The projects using apex credit systems, typically involving a mix of commercial banks and development finance institutions, were more effective as measured by smaller subloan sizes, higher job creation rates with lower costs, and higher subloan repayment rates. Public finance institutions with a general industrial finance mandate performed poorly as single intermediaries in SME loans, particularly in Africa. Subloan sizes have been relatively high, job creation has been low, and repayment rates have been low. The major factors that have contributed to the typical problems of DFIs include weak and frequently shifting leadership, government interference, overall inadequacy and inefficiency, and failure to develop operational strategies consistent with small borrowers.

Most project components designed to provide technical assistance (TA) for entrepreneurs have failed to meet objectives in quantity and quality of services delivered. Poor project design, inadequate preparation and supervision by the World Bank, and poor implementation by government and public institutions were identified as reasons for these poor results. The more successful projects have had fewer TA components, have been specific to a selected group of beneficiaries, were built on an existing successful program, and provide services delivered to groups of persons with similar occupations.

Recent World Bank SME projects, many of which are in Africa, have been designed to 1) promote greater involvement of the private sector in delivering technical assistance to SMEs, 2) broaden microenterprise access to credit and TA, 3) promote female entrepreneurs, and 4) increase the overall number of entrepreneurs. They offer the potential of reaching smaller, and perhaps previously underserved groups through specially designed programs, but the weak institutional capacity of many institutions selected for project implementation is a real concern. The reliance on NGOs in many projects may be problematic, given their typical small size relative to large World Bank projects.

A World Bank report by Dessing specifically analyzes the challenge of supporting microenterprise in Sub-saharan Africa. The report summarizes the literature on various types of programs to assist microenterprises. The author describes the two main strategies for supporting microenterprises as 1) the top-down indirect approach, and 2) the bottom-up direct approach. The first seeks to improve the business environment by changing microeconomic variables such as prices, government regulations and policies, and by building up the physical infrastructure. This "getting-the-prices-right" strategy is consistent with a laissez faire doctrine of government, and relies on people's creativity and initiative to respond to new opportunities and incentives. The second approach aims at supporting microenterprises directly and assumes a more active involvement of the people in necessary structural adjustments. This support often takes the form of credit, training and technical assistance.

Dessing advocates a third approach which combines the so-called process and minimalist approaches. Emphasis is placed on improving access to credit because of the fact that entrepreneurs frequently report it as their most important constraint, and several minimalist credit programs have been successful at reaching a large number of borrowers, especially the Grameen Bank in Bangladesh and the BKK in Indonesia. She advocates an approach in which NGOs, PVOs, business associations and government organizations as second-tier intermediaries are linked with the formal banking system. The second-tier intermediary may eventually evolve or graduate into a formal institution (or bank), whereas the concept of graduating the microentrepreneur, although frequently espoused, is difficult to achieve in practice.

An often neglected aspect of microenterprise support is capacity building/upgrading of the institutions that support these businesses. The quest by donors for short-term visible results mitigates against this longer-term development support. Dessing argues, however, that institution building should be incorporated into the microenterprise support project as an explicit objective, and should be included in the budget. Donors can also assist NGOs by providing management information, by sharing their often more extensive expertise and research documentation, and by helping hire external expertise. There is an inherent conflict, however, that must be resolved in that most NGOs have a social orientation while donors seek economic efficiency. This fact leads some NGOs and PVOs to categorically reject government and donor support.

DEBATE ABOUT THE ROLE OF SMALL SCALE ENTERPRISES

The evaluations reviewed in the previous section reflected a concern for two types of issues. First, the donor agencies are increasingly concerned about the sustainability of their programs. At one time, much of their concern was to document the efficiency of small scale firms that they were committed to assist because of equity objectives. But as evidence mounted that many of the programs they supported are not sustainable, they shifted their attention towards factors that influence sustainability. The current popularity of minimalist credit programs reaching large numbers with efficient operations, high loan recovery rates, and interest rates high enough to cover costs reflects this shift. Instead of detailed targeting of types of enterprises to be assisted, donors now tend to target only the end users, not the end uses.

The second issue which is most evident in the literature surrounding AID and World Bank programs, but largely ignored by other institutions, concerns the economics of the small scale sector. Some of the evaluations recognize the important role of microeconomic policies in affecting the performance of the small scale sector, but don't deeply probe into the question of how the structure of the economy changes with development and growth, and whether it really is useful to assist the small scale sector. The purpose of this section is to highlight some of the issues that are reflected in the debate about the future of the small scale sector in developing countries.

A recent workshop sponsored by AID provided a forum for a review of what has been learned through AID's support of small, micro and informal enterprises.[5] Emphasis was placed on discussing the research conducted in the Employment and Enterprise Policy Analysis (E.E.P.A.) Project. Snodgrass presented a paper which summarized the debate about the role of small and medium manufacturing enterprises in industrialization and economic development. He defined SMEs as firms employing fewer than 100 workers. He argued that India was one of the first developing countries to advocate small scale industrialization as early as its 1956 Industrial Policy Resolution. Subsequent research has documented the positive role of SMEs in the development of China, Taiwan, Japan and Columbia. As noted in the previous section, the research summarized by Liedholm and Mead suggests a positive role for SMEs in several developing countries. The research by Little, Mazumdar, and Page of India and other developing countries, however, arrives at a somewhat different conclusion. They did not find that small, especially very small, manufacturing enterprises are relatively efficient users of resources. In fact, medium size firms often are more efficient.

Snodgrass argued that the industrial structure of many developing countries is dualistic. There are a large number of small firms, a substantial number of large firms with 100 or more employees, and in between the "missing middle" in which there are few firms and relatively little employment. There is also a large diversity in productivity among firms.

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[5] The proceedings of this Workshop are reported in DEVRES.

Labor intensity is greater among industries than among firm sizes, so promoting labor-intensive industries rather than small firms may be a more efficient way of promoting employment.

As countries develop, Snodgrass believes that average firm size rises in manufacturing and productivity and wage differences narrow. The rise in firm sizes occurs for two reasons: 1) the industrial structure shifts in favor of industries in which firms tend to be large, and 2) firm size grows within industries. These trends are due to changes in technology, demand, transportation and information costs, firm strategies, and government policies. Interfirm productivity and wage differentials narrow because of improved economic integration as economies develop and the marginal contribution of resources tends to equalize across firms and industries.[6] Biggs and Oppenheim argue that the aggregate size distribution of firms will be influenced by policy bias with respect to size, to sector or to both. The best way to reduce the share of large firms in manufacturing is likely to be the elimination of bias in favor of industries in which output is concentrated. Furthermore, it will often be counter-productive to implement policies which attempt to improve the competitiveness of small and medium firms.

Following this same line of thought, Snodgrass argues that small firms in low income countries are reservoirs of surplus labor. Only a few have the potential for developing into medium and large firms, and it is difficult to identify them in advance. Policies that explicitly favor small firms, by providing subsidies through differential application of minimum wages, taxes, zoning, etc., can actually inhibit their growth into medium sized firms

[6] A paper by Biggs and Oppenheim presents empirical tests of these arguments.

and accentuate the missing middle. On the other hand, the favorable policy treatment that large firms have obtained for themselves should be eliminated in order to obtain a more level playing field for competition.

The E.E.P.A. series of studies attempted to delineate recommended policies for different types of country situations. Snodgrass advocated a role for active government support of industrialization, including the participation of SMEs, if it is performance-based, such as was the case in Taiwan and South Korea. The trick, of course, is to limit government assistance to those firms that really merit it. The E.E.P.A. research in the Philippines,[7] Ecuador and Honduras concluded that import substitution policies biased against SMEs causing them to remain small and/or informal. It is argued, therefore, that these countries need to reduce their anti-labor and anti-SME policies, and open themselves to more foreign competition.

The African countries pose the largest challenge and disagreement within the E.E.P.A. research project. The Michigan State collaborators in the project argue that micro-level intervention is needed to create the conditions for economic growth. The HIID group represented by Snodgrass, however, is skeptical because they feel that such interventions are expensive and often ineffective. But, they offer no suggestions as to what should be done to create productive SMEs in economically stagnant African countries.

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[7] The Philippines research is reported in Biggs, et. al.

CONCLUSIONS

The most striking difference noted in the several donor evaluations summarized above is the wide range in sizes of loans provided by the various projects. At the low end are the $500-700 loans provided in the AID funded projects. At the high end are the $200-300,000 loans in the EIB funded projects. The World Bank average loan size of $35,000 falls in between these two extremes. The small size loans appear to be focused on simply helping family based firms, while the larger loans seem to be part of projects that aim to increase employment.

In spite of these differences, there is a surprising degree of consensus that emerges in these evaluations. First, the donors are increasingly concerned about project sustainability. This preoccupation seems to arise from the criticism that many donor supported activities either fail during the life of the project, or cannot reach a level of performance so they can continue once the donor support is terminated. Therefore, several evaluations seek to identify those factors that contribute to sustainability.

Second, there appears to be a decline in donor concern about what borrowers are using loans for and the impact the loans are having on them. Some years ago, donors were heavily involved in targeting the end use of loans so that funds would be channeled into so-called productive purposes. There was also a concern about measuring the impact of the projects on the poor. Today, there is a greater appreciation of the difficulty in measuring impact because of the fungibility of loan funds. There appears to be a greater acceptance now that a positive impact can be assumed if entrepreneurs value a program enough to borrow, repay, and become repeat borrowers.

Third, the macroeconomic environment in which small scale firms operate was mentioned in several evaluations as a factor that should be considered when designing a support project. But there is relatively little concrete evidence presented of the extent to which the environment was a major cause of success or failure of a project, or the small scale firms it was attempting to assist. Few guidelines are provided about what specifically should be looked at in project preparation besides the general issue of policy bias towards large scale industries. The extreme view is that projects should not even be undertaken unless the macroeconomic environment is first improved.

Fourth, there appears to be consensus emerging about the characteristics of a successful micro and small scale support project. It should be minimalist providing few services besides loans, reaching thousands of beneficiaries, operating on a commercial basis with interest rates high enough to cover costs, and a strong effort to recover loans. Solidarity group lending is often advocated as the means to efficiently lend and recover loans. Emphasis is on targeting the poor as end users of loans, but not the end uses. Loans should be directed towards enterprise expansion, rather than enterprise formation or transformation. Institutions to implement projects should be screened carefully, and many require considerable assistance themselves before they can efficiently operate loan programs.

Fifth, NGOs and PVOs are advocated as preferred implementing institutions, but there is a concern about how many are actually capable of the task. Like government agencies, many require considerable strengthening because their strong advocacy and commitment to the poor is not a sufficient attribute for operating a sustainable program.

A sixth characteristic of these evaluations is their concern for client graduation. Most projects operate on the assumption that after an initial period of special assistance, small scale entrepreneurs will be able to graduate to a commercial banking institution to get loans. But in practice this rarely happens so there are suggestions that entire programs should eventually evolve or graduate into commercial institutions.

Seventh, it is rather surprising that the evaluations say so little about savings mobilization. Increased attention to savings could have three benefits. First, savings mobilization would give support institutions another source of funds to help offset the uncertainties of donor or government funds. Second, some small scale entrepreneurs will benefit as much from a secure place to hold their savings as they will from getting loans. Third, encouraging entrepreneurs to save will help them to develop the concept of a continuous banking relationship, usually necessary for graduation to a commercial institution.

Eighth, except for AID, donors support surprisingly little analysis about the role of small and medium enterprises in the development process. The sustainability and growth of support services to these enterprises is inextricably linked to how well the sector performs over time. For example, firms that subsist on producing inferior goods will find it difficult to survive as incomes rise and consumers seek higher quality products. Providing support for these firms will accomplish little.

A ninth point that emerges is that the documentation available to evaluators is generally of poor and irregular quality. This appears to be a problem both for project design documents as well as monitoring and evaluation reports. This casual approach to documentation may help explain the unbusinesslike institutions that donors often support.

Finally, the tenth observation is that none of the evaluations proposed that the donor discontinue or reduce its support for the small scale sector in spite of all the difficulties identified by the evaluations in past projects. This reflects an optimism that past shortcomings can be rectified. It probably also reflects a certain pragmatism by the evaluators; support for microenterprises is currently an important donor "fad" and funds will be pumped into these projects until a new fad comes along to replace it. Furthermore, a strong NGO and PVO constituency has been built up that will continue to pressure for its involvement in these types of projects.

Table 1

KEY RESEARCH FINDINGS

Item	Enterprise Formation	Enterprise Expansion: Total	Enterprise Expansion: Financial Institution	Enterprise Expansion: Micro-Enterprise Program	Enterprise Transformation	Statistically Significant[a]
Number of projects	6	22	6	16	14	--
Average Years in Operation	3.7	4.0	7.3	2.7	2.3	yes
Average Number of Annual Beneficiaries	328	87,871	393,172	642	264	yes
Average Percentage of Women Beneficiaries	59	43	41	43	27	no
Average Percentage of Beneficiaries in Manufacturing	54	40	23	44	60	no
Average Program Cost per Beneficiary ($)	948	575	N.R.	575	2,549	no
Average Loan Size ($)	508	705	676	714	3,261	yes
Average Loan to GDP per Capita	1.3	1.2	2.2	0.9	10.2	yes
Average Percentage of Fixed Assets Loans	25	20	9	26	45	no
Average Program Cost per Dollar Lent ($)	3.24	0.46	0.51	0.43	1.08	yes
Average Real Interest Rate	3	23	17	25	0	no
Percent of Loan Funds in Arrears (%)	24	17	22	16	18	no

[a]Statistically significant at the 5 percent level.

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